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SUBJECT: KENYA GDP GROWTH AND INFLATION STAY STRONG

¶1. Summary: The Statistics Bureau estimated that real GDP grew 7.1% year-on-year (YOY) in the second quarter of 2007, based on growth in all sectors. Overall seasonally-adjusted inflation in the second and third quarters remained above 10%, and underlying inflation hit the Central Bank's 5% warning level. Forecasts for 2007 and 2008 growth remain around 7%, despite the general election campaign. Fitch Credit rating agency gave Kenya a B+ stable outlook rating. Analysts are concerned, however, that high inflation, campaign promise-expanded government deficits, and infrastructural bottlenecks could constrain growth in 2008. End summary

Economy Continues to Grow Strongly

¶2. The Kenya National Bureau of Statistics (KNBS) revised its first quarter real GDP growth rate upwards from 6.3% to 6.6% YOY. For the second quarter of 2007, KNBS estimated real GDP growth accelerated to 7.1% YOY. Agriculture grew 5.4% in the second quarter, with exports of cut flowers up 7.7% and vegetables jumping 26.2% YOY. Manufacturing output grew 8.6% YOY, a significant increase over the Q2/2006 rate of 4.9%. Production of food products rose 9.7% and non-food items rose 8.1%, indicating broadly-based strength in the manufacturing sector. The hotel and restaurant sector grew 11.1% in the second quarter, but overall tourism receipts in the first thee quarters of 2007 leaped 18.6% YOY to Sh49.2 billion ($757 million). Communication, transportation and utilities all reported strong growth in the second quarter as well.

¶3. GOK tax revenues also benefited from the robust growth. Kenya Revenue Authority (KRA) collections in the third quarter exceeded the Ksh 98.6 billion ($1.5 billion) target by 3%. The depreciation of the dollar against the shilling caused shilling-denominated export earnings to fall, but cut the costs of imports, and buffered somewhat the rise in oil prices.

Inflation Remains High

¶4. Average annual (seasonally-adjusted) overall inflation stayed between 10% and 11% in the second and third quarters, driven especially by food, energy and housing price increases. In the months of June-September, the Nairobi lower income group especially faced significant increases in their cost of living. YOY underlying inflation (which excludes volatile food, energy, and transport-communications) stayed above 5% in Q2 and Q3, peaking at 5.6% in July. Average annual underlying inflation rose steadily through both quarters, and finally reached the Central Bank of Kenya's (CBK) 5% target ceiling for monetary management in October. Broad money supply continued to climb strongly as the economy expanded, despite CBK's efforts to mop up liquidity through repo sales.

¶5. Overall inflation fell slightly from its August peak of 10.7% to 10% in November, but appears likely to remain in the double digits for 2007, driven by high world energy and food prices, plus strong investment in real estate (driven partly by growing remittances). Underlying inflation is likely to remain above the CBK's target rate, but analysts hope the CBK will improve its control of the money supply after the election and its constraints on interest rate hikes is over on December 27.

Outlook Remains Strong

¶6. Although some analysts had expressed concern the uncertainties caused by the December 27 general election might cause some investors to hold back and thus slow growth, the private sector remained buoyed by strong fundamentals. Fitch credit rating agency gave Kenya a B+ stable outlook rating, citing Kenya's diversified economy, large and vibrant private sector, and developed financial markets. Fitch predicted the election would not materially affect the direction of economic policy. A recent survey by Reuters showed an overall expectation that economic growth would remain about 7% in the second half of 2007 and the first half of 2008, supported by strong exports, tourism, and the continuing sale of parastatals to fund the GOK's budget. Analysts were divided whether the shilling would continue to appreciate against the dollar, and some expressed concern that high inflation could reduce consumer spending that has become a powerful engine for growth.

Candidates Promise Increased Spending

¶7. All the presidential candidates promised to increase spending on education, health, infrastructure, agriculture, and other initiatives. If translated into budget allotments, the GOK will need to find more money. The Kibaki administration planned to launch a $300 million Euro bond in 2008 to fund infrastructure projects, aided by the Fitch and S&P sovereign credit ratings. Analysts worried the GOK might also have to increase borrowing in the domestic market, raising interest rates and cutting into private investment and growth.

Comment

¶8. Kenya's economic fundamentals are strong, and whoever leads the next government is likely to maintain Kenya's generally sound macro-economic management, despite all the campaign promises. Overall inflation in the 10%-12% range does not seem to deter growth, but it puts workers and low income groups in a squeeze, and requires a stronger CBK response. Kenya's robust growth is running into bottlenecks, including energy production, transportation infrastructure, and hotel space. Nairobi traffic is now at a stand-still for long periods of each day, yet auto imports continue unabated. If plans for infrastructure expansion are not implemented swiftly, these bottlenecks could constrain growth below expectations.

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